

## **The economic effects of the European Neighbourhood Policy**

### **Abstract**

*This article investigates the potential economic effects of ENP. It asks three questions. First, whether the adoption of parts of the EU acquis, required to obtain a higher degree of integration with the Internal Market, would constitute appropriate structural reform, in the form of a growth-enhancing upgrade in the regulatory environment. Second, how much additional growth might be mobilised by a successful implementation of the ENP. Third, whether the ENP can provide credible and significant political incentives to the countries of the EU's neighbourhood to implement the necessary reforms. It argues that to succeed in the long run, the ENP must be concrete, ambitious and cover effectively a wide range of policy areas. Ultimately, the ENP's fate will depend on how the value added through closer integration with the EU, politically and economically, compares with the costs of meeting the benchmarks and conditions that the EU will set on the road to deeper integration.*

### **Introduction**

Although still in its inception phase, the European Neighbourhood Policy (ENP) has scored two clear successes: the high rate of acceptance by the EU neighbours and the utilisation of the ENP as a concrete answer to Ukraine's aspirations for quick EU membership following the 'Orange revolution' of November and December 2004. Although the EU's cautious response to Ukraine's membership bid may have disappointed some proponents of early accession, the availability of a concrete ENP programme provided the EU with a third choice from having to say 'yes' or 'no' to Kyiv under short-term political constraints; it might also have spared the Ukrainian side from an embarrassing rejection. On the negative side, the only setback was Russia's refusal to join the ENP. Overall, so far the successes of the policy seem to clearly outweigh its shortcomings.

Nevertheless, the ENP should not be judged solely on its virtues as one more element of a foreign relations toolbox. The ENP was primarily conceived as an instrument to further *prosperity* and *stability* in the EU's neighbourhood. Hence, it aims at having a positive and tangible effect on the societies and economies of participating countries. This chapter deals with its economic impact.

### **The economic dimension of the ENP**

The economic strategy of the ENP is to strengthen growth through a tighter integration of the EU's Neighbouring Countries (henceforth NCs) with the EU economy. This is to be achieved through a number of policy measures negotiated and agreed with the NCs governments and listed in ENP 'Action Plans'. Specifically, on the economic front, the ENP offers NCs:

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<sup>1</sup> European Commission. The views expressed here reflect the personal views of the authors, which do not necessarily coincide with the Commission's position.

- enhanced preferential trade relations, leading in the medium-term to the establishment of Free Trade Areas;
- ‘a stake’ in the EU Internal Market dependent on progress in implementing the EU *acquis* and other accompanying reforms;
- increased financial and technical assistance through the European Neighbourhood and Partnership Instrument;
- improved interconnection with the EU in areas such as energy, transport and the information society;
- the opportunity to participate in EU programmes (such as research and education).

The perspective of a stake in the Internal Market is the most novel and far-reaching aspect of the ENP. Although progressive and a long-term goal, NCs are offered the opportunity to participate in the economic cornerstone of the EU integration, namely an area of free movement of goods, services and factors of production. This would require progressive convergence to Internal Market rules, coupled with stepped-up consultation and cooperation, and an adaptation of institutional practices to EU standards. With the ENP, for the first time the possibility of participating in the Internal Market is offered to non-European countries which are economically and socially very different from the EU. This can explain the caution used by the EU in official texts where reference is made to ‘obtaining a stake’ and ‘perspectives for participating progressively’ in the Internal Market. In particular, the perspectives for the complete liberalisation of trade in agricultural products and of labour movements have been left open. It is thus more appropriate to see the ENP as a ‘process’, rather than a defined objective of full market integration.

Notwithstanding the above limitations, the ENP has the potential to deliver economic benefits for the neighbours. Specifically, the ENP can be expected to have an impact on economic growth through three conceptually separate, though practically interrelated, channels:

1. **Structural reform:** a successful application of the ENP should result in an upgrade of the regulatory framework of the NCs to make it more conducive to growth;
2. **Macro policy anchor:** closer adherence to sound monetary and fiscal policies should provide a better macroeconomic environment;
3. **Trade and factor movement:** a reduction in tariff- and non-tariff barriers to the movement of goods, services and factors of production between the EU and the NCs, and eventually also between NCs, should induce growth through the customary beneficial effects of trade liberalisation;

There is wide consensus in the economic literature on the fact that ‘the right kind’ of structural reform, sound macro policies and trade liberalisation are beneficial to growth. Three questions, then, are of fundamental importance: first, whether the adoption of parts of the EU *acquis*, required to obtain a higher degree of integration with the Internal Market, would constitute appropriate structural

reform, i.e. a growth-enhancing upgrade in the regulatory environment; second, how much additional growth might be mobilised by a successful implementation of the ENP; third, whether the ENP can provide credible and significant political incentives to NCs to implement the necessary reforms.

### **The ENP and growth-enhancing structural reforms**

The existence of the first growth channel, structural reform, assumes that the Internal Market institutional setup is superior to the one existing in the NCs. Although EU critics often regard its body of regulation as cumbersome and detrimental to growth, various arguments plead for the existence of beneficial economic effects from integration within the Internal Market:

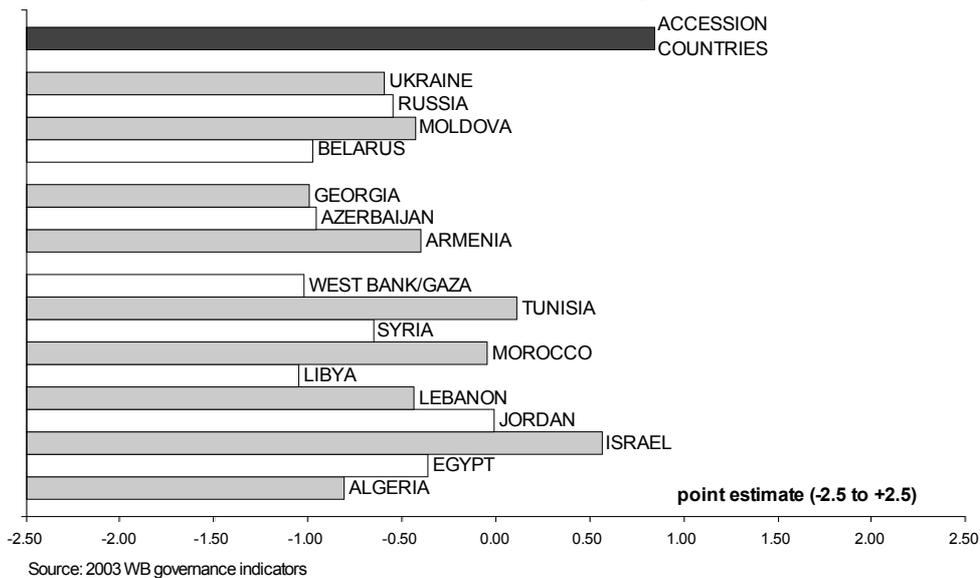
- **The EU regulatory environment is superior to that in the NCs.** A comparison between the regulatory environment of NCs and the EU accession countries, which have taken on the *acquis communautaire* as a prerequisite to joining the Union, offers useful insights. Chart 1 reports the scores obtained by NCs on a synthetic indicator for governance based on World Bank research<sup>2</sup>. It shows a clear positive difference between the scores of EU accession countries and that of NCs, suggesting that adopting the EU *acquis*, irrespective of any imperfections, would still represent an improvement over the *status quo*. The potential for improving the economic environment in NCs appears, indeed, significant. All NCs, both the Mediterranean and the Eastern ones, have a history of extensive state intervention in the economy; this has left behind a legacy of regulations that even after a decade or more of reform, are inadequate to the needs of modern economies. There is wide consensus on the key role played by EU accession in fostering structural reforms<sup>3</sup>; by opening to NCs the prospect of participating in the EU Internal Market, the ENP aims precisely at replicating this effect.

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<sup>2</sup> The indicator is an average of the score for 6 indicators developed by the World Bank: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law and control of corruption. As any composite indicator measuring qualitative factors, it should be used with caution.

<sup>3</sup> The EBRD 2003 Transition report (*passim*), among others, notes that EU accession countries have outperformed other transition economies in terms of structural reforms.

**Chart 1: Governance in the EU neighbourhood**



- **EEA experience.** Additional evidence of the economic benefits from participating in the Internal Market can be found in the fact that EFTA members have voluntarily agreed to *de facto* forfeit parts of their economic sovereignty to join the EEA; one can otherwise see no reason why countries that have traditionally been lukewarm to the EU would have entered into an economically disadvantageous commitment, the more so given the absence of any EU funding.
- **Business support for the EU.** The business community has generally been amongst the strongest supporters of the EU in all countries contemplating membership. Once more, this can be taken as evidence of positive net economic gains from integration in the Internal Market<sup>4</sup>.

### **The ENP as a macroeconomic policy anchor**

Besides the stimulus to structural reform, the ENP is also expected to promote adherence to sound macroeconomic policies. All Action Plans foresee that the NCs should, as a minimum, commit to sustainable fiscal and monetary policies. Apart from its beneficial growth impact, macroeconomic stability boosts the positive effects of liberalisation, while minimising the risks inherent in a higher level of integration with the EU Internal Market. Indeed, it is often argued that sustainable and welfare improving liberalisation cannot be achieved in the absence of macroeconomic stabilisation<sup>5</sup>. In particular, the liberalisation of financial flows needs to rest on sound macroeconomic policies to reduce the risk of financial turbulence. Economic liberalisation is also more likely to succeed in a

<sup>4</sup> One could argue that this is due to the prospect of receiving EU structural funds. However, even in the Nordic countries, net contributors to the EU budget, business has generally supported EU membership.

<sup>5</sup> S. Nsouli, M. Rached, N. Funke 'The speed of adjustment and the sequencing of economic reforms : issues and guidelines for policymakers', IMW WP, August 2002.

context of satisfactory economic growth, which allows agents to bear more easily the adjustment costs<sup>6</sup>.

Although perhaps less prominent than those concerning the Internal Market acquis, the importance of the Action Plan commitments on macroeconomic sustainability should not be underestimated; NCs economic policies will be monitored and discussed regularly in a bilateral context, bringing more attention to them and introducing, at the very least, an element of ‘moral suasion’ and the possibility of a negative fallout on relations with the EU in the event that the policies followed are unsustainable.

Table 1 gives a snapshot of the ENP area in terms of a number of basic macroeconomic stability indicators. Most NCs appear to be currently enjoying relatively favourable macroeconomic conditions, given GDP growth above 2% in most of them. However, macro imbalances remain. If, on a purely illustrative basis, one were to hypothetically assess macro performance in the NCs with the EU ‘classic’ benchmark of fiscal policy orthodoxy, the Stability and Growth Pact, one would find that around half of the countries would not satisfy its requirements.

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<sup>6</sup> S. Gupta, E. Baldacci, B. Clemens, E. Tiongson ‘What sustains fiscal consolidation in emerging market countries?’, IMF WP/03/224, November 2003.

**Table 1: Macroeconomic stability in the EU neighbouring countries: key indicators (2003)**

	Algeria	Armenia	Azerbaijan	Belarus	Egypt <sup>1</sup>	Georgia	Israel	Jordan	Lebanon	Libya (proj.)	Moldova	Morocco	Russia	Syria	Tunisia	Ukraine	WB&Gaza
Real GDP growth (% change)	6.8	13.9	11.2	6.8	3.1	11.1	1.3	3.2	3.0	4.6	6.3	5.5	7.3	2.5	5.6	9.3	4.5
Unemployment rate (% workforce)	26	10.1	10.7	3.1	9.9	11.5	10.7	15.0	NA	NA	7.9	11.6	8.1	10.3	14.3	8.7	26
GNI per capita (USD) <sup>2</sup>	1890	950	810	1590	1390	830	16,020	1850	4040	3900	590	1320	2610	1160	2240	970	1110
CPI inflation (%)	2.6	4.7	2.2	28.4	3.2	4.8	2.2	2.3	1.3	2.8	11.6	1.2	13.7	4.3	4.4	5.2	1.1
Central government balance (% GDP) <sup>3</sup>	3.5	-4.3	-0.1	-1.1	-6.8	-2.5	-8	-13.2	-14.6	7.0	-1.6	-5.4	1.7	-3.5	-3.3	-0.7	NA
Public debt, gross (% of GDP) <sup>4</sup>	48.1	NA	NA	10.4	114.5	62	106.5	100	184.3	26.8	62.2	68.2	28.3	116	58.9	32.1	NA
External debt (% of GDP) <sup>5</sup>	33.6	38	21	4.4	36.4	49	61.9	77.1	43.4	29.0	51.5	36.1	42.5		60.3	28	NA
Current account balance (% of GDP)	11.3	-7.1	-28.3	-2.6	2.4	-7.9	0.4	11.2	-12.7	28.8	-7.4	3.1	8.3	5	-2.9	6.1	-13.9
Import cover (months) <sup>6</sup>	22.8	4.1	2.1	0.5	8.7	1.4	6.7	8.2	11.6	23.6	2.1	10.3	12	9.1	3.3	2.8	NA

1 Fiscal year 2002/03 for Egypt

2 WB, Atlas method for 2003 except for Libya

3 excluding grants except in Ukraine and Moldova, including Finds Hassan II for Morocco and Price Stabilisation Fund for Syria

4 2002 data for Algeria and Libya, domestic public debt for Libya, external public debt for Moldova

5 2002 data for Libya

6 Official reserves in months of imports of goods and non factor services

Sources: Compiled from a variety of official and unofficial sources and shown for illustrative purposes only.

## Effects on trade and factor movement

The magnitude of the benefits of trade liberalisation will depend on the degree to which the ENP effectively reduces tariff- and non-tariff barriers, and on their impact on trade volumes. The EU is in almost all cases the first trade partner for ENP countries, and the ENP-mandated removal of tariff and non-tariff barriers to trade should further reinforce this pattern<sup>7</sup>. In the case of trade in industrial goods, the potential for welfare gains is particularly strong for the Eastern NCs which, in contrast to the Mediterranean NCs, still face tariff protection by the EU for certain goods<sup>8</sup>. On the other hand, both Eastern and Mediterranean NCs should greatly benefit if the prospects tentatively offered on liberalisation of agricultural trade materialise.

Eastern and Mediterranean NCs are also expected to benefit from the reduction of non-tariff barriers on trade with the EU, which often constitute significant hindrances to trade and are mainly associated with the non-alignment to Internal Market legislation (such as in the areas of standards and conformity assessment) and customs procedures. Liberalisation of trade in services prompted by the ENP should also be very beneficial given the neighbours' background of inefficient or underdeveloped services. Exposure to competition is expected to bring about efficiency gains both in the service sectors themselves and in sectors that rely on services as an input.

As for movement of factors, if it takes place within a balanced macroeconomic environment, the liberalisation of capital movements has a potential for large positive effects, including efficiency gains in the allocation of savings, increased access to foreign markets to finance trade and investments and diversify portfolios, and higher competition and efficiency in domestic financial markets. Nevertheless, the liberalisation of capital movements is fraught with substantial risks and needs to proceed cautiously. Free movement of workers also promotes an efficient allocation of labour resources. An eventual easing of labour migration from the NCs to the EU, besides adding flexibility in the labour market, would make the problem of population ageing in the EU less acute and diminish demographic pressures in those NCs with high population growth, i.e. the Mediterranean NCs. Nevertheless, the prospect of large scale migration from the NCs to the EU is politically very sensitive, and the extent to which the ENP foresees free movement of labour in the long term is as yet unclear.

### **What might be the order of magnitude of the economic benefits from the ENP?**

If the ENP is successful in fostering growth through integration with the Internal Market, structural reforms and better macro management, it seems reasonable to expect some replication of the catching-up process which has been witnessed in the

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<sup>7</sup> It should be noted that most NCs are pursuing several trade liberalisation initiatives, regionally or on a bilateral and multilateral basis, which may affect trade patterns. Several Mediterranean countries have concluded regional free trade agreements or with the USA; in the East, Russia, Ukraine, Kazakhstan and Moldova have established a Single Economic Space. A number of NCs are WTO members or in the process of acceding to it.

<sup>8</sup> Such as some chemical products, wood and metals.

EU after successive enlargements<sup>9</sup>. The strength of these effects will clearly depend on whether a ‘critical mass’ of Internal Market regulations and macroeconomic reforms are implemented by the NCs in a satisfactory manner. If the ENP process can be likened, in qualitative terms, to a weaker form of membership of the EU economy and economic model, it seems logical to assume that the economic effects of the ENP will be analogous, although less pronounced, to those witnessed by accession countries during previous EU enlargements. Notably, the ENP can be expected to lead to an increase in the share of trade and to larger factor movement between NCs and the EU and to a greater synchronisation of NCs’ business cycles to the EU’s.

Existing analyses of the growth impact of the 2004 EU accession round *prima facie* constitute an upper bound to the benefits from economic integration and thus *a fortiori* to possible gains from the ENP. The Wim Kok report on the enlargement of the EU, citing various studies, estimates the trade-induced economic benefit from EU membership at between 1.5% and 8% of GDP for the accession countries and at 0.2% for the EU15<sup>10</sup>. In the case of the ENP, the benefits would not be evenly spread across the region, but accrue primarily to those NCs which have a high share of trade with the EU. NC exports to the EU vary widely, from less than 10% in Jordan to a high of over 70% in Morocco and Tunisia<sup>11</sup>. Growing integration would of course tend to increase the EU trade share over time.

### **Does the ENP offer credible political incentives to reform?**

In principle, achieving the ENP aims in the economic area would not necessarily require binding closely to the EU, as each of the three growth-enhancing channels identified above might be pursued through other means. In fact, trade liberalisation might just as well be achieved in multilateral fora (notably the WTO), while structural reforms and macroeconomic stabilisation are already the remit of the World Bank and of the International Monetary Fund. Nevertheless, there are reasons to believe that, compared to the *status quo*, the ENP offers value added in so far as it can be expected to provide stronger political incentives for economic reform in the NCs as well as a series of practical advantages, that would be expected to speed up and ease implementation of pro-growth policies.

*Stronger political incentives.* Usually, the continuation of bad economic policies -in NCs and elsewhere- is not due to lack of proper economic advice but rather to lack of political support for structural reform, which generally entails short-term political costs and provides benefits only in the long-term. If the ENP could reinforce political incentives for reform, it might provide a significant boost to long-term growth.

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<sup>9</sup> One must however bear in mind that an important difference between full EU membership and the ENP is that NCs will not be eligible for EU structural funds. Nevertheless, the ENP calls for a reinforcement of current financial assistance to NCs.

<sup>10</sup> W. Kok, ‘Enlarging the European Union, Achievements and Challenges’, Report of Wim Kok to the European Commission, European University Institute, Robert Schuman Centre for Advanced Studies, 2003.

<sup>11</sup> M. Dodini, M. Fantini, ‘The EU Neighbourhood policy: implications for economic growth and stability’, *Journal of Common Market Studies*, *forthcoming*.

In our view, the ENP programme may offer the NCs stronger incentives to carry out reforms -compared to the *status quo*- in the following ways:

- **A richer offer.** Although the final objectives of the ENP are not yet fully defined, the long-term aim of widening the borders of the Internal Market and strengthening relations goes beyond the prospects currently offered by multilateral trade negotiations. The envisaged increase in funds directed at cooperation with NCs would also increase incentives.
- **Political communicability.** Convergence with the EU economic model may be more appealing and easier to communicate than adhering to the policies advocated by the International Financial Institutions, which have been the subject of some controversy. The regional dimension of the ENP might also help, by generating political pressure to avoid ‘falling behind neighbours’ and stimulating ‘peer pressure’ amid NCs.
- **Package effect.** The broad range of the EU’s relations with the NCs allows it to profit, in negotiations, from a ‘package effect’, whereas proposals that would not be accepted in isolation find backing if they are bound together in a comprehensive reform package- something which sectoral organisations (like the Bretton Woods institutions) are less capable of doing.
- **Growing EU influence in the region.** The EU has gradually been boosting its foreign policy ambitions, particularly in its neighbourhood. If the drive to give the Common Foreign and Security Policy greater clout is successful, the incentives for NCs to seriously engage in the ENP would also increase.
- **Less ground to cover on the way to membership.** Although there are no (formal) links between the ENP and EU membership, a successful participation in the ENP can be a very effective tool to demonstrate European credentials for those NCs hoping to eventually join the EU; moreover, all progress made in the ENP framework would reduce future efforts to prepare for EU membership.

*Practical advantages.* The ENP offers countries a **ready-made regulatory framework**. For countries wishing to put in place a modern regulatory framework, adopting the EU *acquis* as a reference is likely to be easier than developing a new one from scratch. Although this argument is purely practical, it may carry substantial weight in countries where the administrative capacity is relatively weak. Furthermore, if the ENP succeeds in involving most NCs, the approximation of legislation should facilitate economic integration not only between individual NCs and the EU, but also among NCs.

Part of the incentives identified above (in particular those linked to membership and those linked to a reduction of trade barriers), apply more to the Eastern neighbours than to the Mediterranean ones. It is thus theoretically possible that the ENP will be more effective in fostering reform in the former than in the latter. This outcome, however, would show that the ENP concept of an intermediate status between membership and non-membership fundamentally lacks attractiveness.

### **What risks can derive from the ENP?**

The implementation of the ENP does not seem likely to create major risks of economic and financial instability<sup>12</sup>. Nevertheless, the very design of the ENP involves two important regulatory risks both to the NCs – in the form of possible overregulation – and to the EU – in the form of risks to the integrity of the Internal Market.

*Risk of overregulation.* Internal Market regulation consists of several thousands pages of legislation, often highly technical, which was not devised having in mind the prospect of adoption by less economically developed countries. Hence, many of its provisions might be irrelevant, inadequate or even harmful for NCs. Premature adoption of the *acquis* would not only risk saddling the private sector with compliance costs, but might also divert administrative resources away from higher priority tasks.

*Risks to the integrity of the Internal Market.* The offer to NCs of a stake in the Internal Market should not lead to the unravelling of what has been achieved at considerable effort in the EU over the last decades. The mere adoption of legislation by all participants is insufficient to safeguard the functioning of the Internal Market. The Internal Market relies on a high level of mutual trust between administrations and on an equivalence of regulatory and enforcement approaches, as any failure to apply the common rules in one part of the Internal Market puts the rest of the system at risk. In addition, the successful functioning of the Internal Market assumes the fulfilment of a wide range of basic conditions, including appropriate, transparent and stable administrative, judicial and legal structures; a sophisticated market economy; open and fair competition; and a common framework which ensures that minimum social standards and adequate protection of the environment apply. Thus, in order to preserve the functioning of the Internal Market the EU will have to ensure that NCs not only approximate their legislation to Internal Market requirements, a complex but straightforward process, but also that they adapt their administration to ensure effective implementation and meet the requirements underlying an open and fair market economy.

An additional complication is that there is as yet no ‘theory’ prescribing firmly what elements of Internal Market legislation are essential to its functioning, both from the perspective of new participants and existing ones, and which elements may instead be left aside. The decision on what parts of the *acquis* should be taken on board by the NCs will be the result of negotiations. At the extremes, this can lead to two risks: the first is overregulation; the second is its mirror image –that, perhaps in exchange for high-profile concessions in non-economic areas, the EU is too indulgent on *acquis* implementation by NCs, which may lead to a hollowing out of the Internal Market. The latter risk is heightened by the likelihood that any agreement on Action Plans is achieved as a ‘package deal’, whereby a technically important but politically low-profile regulatory aspect might be sacrificed in exchange for a commitment in a high-visibility area such as human or women's rights, etc.

## **Conclusions and policy recommendations**

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<sup>12</sup>For a full discussion of this point see Dodini, Fantini, *op. cit.*

This chapter suggests that, in addition to its significance as a political tool, the ENP has a potential to foster economic growth in neighbouring countries. It identifies a number of ways through which this might happen, both directly through economic channels such as trade liberalisation and indirectly, by providing an anchor for proper structural and macroeconomic policies.

*Prima facie*, the ENP seems to offer ‘added value’ both to the existing framework of EU-NC relations and to the currently available multilateral fora. Although it is too early to predict whether this will be sufficient to generate and maintain political support for economic reforms, the initial reaction to the ENP has been broadly positive. Nevertheless, to succeed in the long run, the ENP must be **concrete, ambitious and cover effectively a wide range of policy areas**; the positive effects on NCs’ economies are likely to be significantly stronger should the ENP be extended to trade in agricultural products. Ultimately, the ENP's fate will depend on the extent to which the value added stemming from tighter integration with the EU compares, politically and economically, to the costs of meeting the benchmarks and conditions that the EU will set on the way to greater integration.

In the medium-run, successful participation in the ENP requires that the pace of convergence to the EU and the NCs’ process of economic reform are matched. Notwithstanding the validity of the general concept of the ENP, the concrete contents of the Action Plans will determine their realism and attractiveness to each individual NC; the EU ‘offers’ will have to be in balance with the ‘requests’ it makes to NCs at all times. Ownership of the ENP programme by the NCs, consistency with their development goals and implementation capacity, as well as ability to lead to visible improvements in living standards are key to its long-term success. The economic policy dialogues that the European Commission holds regularly with most NCs provide a useful tool to ensure that these requirements are met.

This chapter also highlighted a number of issues that policy makers will have to attend to while implementing the ENP. In addition to assuring the effective implementation of measures agreed in the Action Plans, real choices will have to be made about which elements of the *acquis* should be taken on board by the NCs. The adoption of Internal Market rules or convergence to their principles by NCs does not *per se* preclude a selective and gradual approach. To minimise the twin risks of over-regulation and of the hollowing out of the Internal Market, participation in it should be constantly proofed and proceed gradually. Both the NCs and the EU should take full advantage of the ENP principle of ‘differentiation’, which stipulates that Action Plans must be tailored to the realities and needs of each NC, and keep a priority-based approach to regulatory alignment.

